

Statement of
Kevin Stein, President, Chief Executive Officer and Director
TransDigm Group Incorporated
Before the Oversight and Reform Committee, U.S. House of Representatives
Hearing on "DoD Inspector General Report on Excess Profits by TransDigm
Group, Inc."
May 15, 2019

Chairman Cummings, Ranking Member Jordan and Members of the Committee:

Thank you for the opportunity to appear before you today and answer your questions about TransDigm Group Incorporated. I am joined by the company's Executive Chairman and founder Nick Howley.

Mr. Howley and I are here this morning to talk with the Committee about a recent audit by the Department of Defense's (DoD) Office of the Inspector General (IG) of whether the DoD bought certain spare parts from TransDigm at fair and reasonable prices. We understand that the Committee is inquiring whether TransDigm has been appropriately earning excess profits with taxpayer funds, and whether federal acquisition regulations adequately equip contracting officers to negotiate fair and reasonable prices for spare parts from sole source manufacturers.

As a threshold matter, we respectfully ask that the Committee take notice of the fact that the IG did not audit or (to use the colloquial term) "investigate" TransDigm. Rather, it audited the procurement practices of the Defense Logistics Agency (DLA) and other government buying agencies. In doing so, the IG found that TransDigm did nothing in contravention of the federal acquisition laws and regulations with respect to its pricing.

Introduction

Founded in 1993 and headquartered in Cleveland, Ohio, TransDigm is a leading global designer, producer and, supplier of highly engineered aircraft components. TransDigm makes a wide range of products—from faucets, seat belts and wall coverings to parachutes, actuators, valves and winches; from cargo systems to cockpit-door security systems. TransDigm has products on nearly all commercial and military aircraft in service today. However, TransDigm is not a traditional defense contractor—it is primarily a commercial company. When I say TransDigm is primarily a commercial company, I mean that our primary customers are commercial aircraft manufacturers, such as Boeing, AIRBUS, and Cessna, and the airlines and other commercial end-users of those airplanes. Worldwide defense revenues are about one-third of TransDigm's consolidated sales. About 5-6% of our sales are direct to the U.S. government. Roughly, 2% of TransDigm's sales are through independent distributors to the U.S. government. The rest of our defense sales are to U.S. defense contractors, foreign defense contractors, and friendly foreign governments.

TransDigm operates in the commercial marketplace with the support of approximately 21,000 employees worldwide, about 11,000 of whom are located in the United States. Our domestic operations span 20 states, including Ohio, New York, California, Illinois, Florida, Connecticut, Arizona, North Carolina, South Carolina, and Texas.

With this workforce, TransDigm operates through 123 subsidiaries that report as 54 operating units. Each operating unit is independently run by its own management team.

Collectively, the operating units operate 134 manufacturing locations and have over 200,000 product SKUs.

In general, each operating unit shoulders the research and development costs of the products it makes and sells. Importantly, the DoD rarely funds the cost of developing the products that TransDigm sells to it—most of TransDigm's defense sales are of products developed from commercial parts or of a type sold commercially. As TransDigm is primarily a commercial company, its business model is very different from that of traditional defense contractors receiving cost-based contracts. However, its model is common in the commercial aerospace, automotive, marine, and other industries.

Briefly, in these industries, it is common that parts are developed for an original equipment manufacturer (OEM), often at the supplier's risk and expense, and sold to the OEM at cost or low profit margins. After years of selling parts to the OEM for use in their original manufacture of articles—airplanes, cars, or boats—the suppliers are able to realize higher margins and finally achieve an attractive return on their capital investments in the “aftermarket” by selling the same parts or subcomponents to end-users as spares at higher prices. This “razor/razor blade” pricing strategy is common in the industry.¹

Indeed, on May 18, 2017, then-Director of Defense Pricing Shay Assad observed how important it is for the government to rely on suppliers using their own capital to do research and development to bring new products to market and compete to place products on new aerospace platforms:

There are legitimate companies that we do business with that make significant investments in the commercial marketplace and we need to recognize that. We've got the total benefit of the research and development and the work that they paid for on their own nickel. So, therefore they should have a right to recover that over time when they're selling commercial products to us.²

It is also important to note that TransDigm makes specially-designed parts in very small quantities. These parts are made-to-order. Usually, we're not pulling them off a shelf in a warehouse. At the OEM level, after months or years of development and testing, we might make parts for a few dozen to a few hundred planes per year. After the airplane goes out of production, we have to support the aftermarket for as long as the planes fly—often decades. For example, the life of the B-52 has been extended to at least 2050—98 years from its first flight and decades after production ended.

That means that we are supplying parts to DoD in order sizes as small as one part and sometimes it is years between orders of a part. When an order for an out-of-production part comes in, we may have to order new materials (and possibly find a new supplier), switch machine settings, switch or redesign tooling, and set-up and calibrate testing equipment. Many times, manufacturing personnel have to re-learn how to make the part. These contracts may be

¹ As described in a January 2017 report on TransDigm by Bank of America/Merrill Lynch, “[TransDigm's] pricing policies are in line with aerospace industry standards. Aerospace suppliers tend to have a ‘razor/razorblade’ pricing strategy. They tend to make investments in product development that are recovered on spare part sales, not OEM parts. A typical multiple for aftermarket parts compared to OEM parts in Aerospace is 10X. Thus, a \$100 OEM part could sell for \$1000 in the aftermarket. Using this model, when factoring in development costs, very little money is made in the OEM market, but investments are recovered in the aftermarket. This is common across the aerospace industry, especially for sole source parts.”

² Remarks, Shay Assad, Director, Defense Pricing, Department of Defense, at “The Capitol Forum—Defense Procurement in the Trump Administration,” Hyatt Regency Washington on Capitol Hill, May 18, 2017.

rated orders under the Defense Production Act. That means we must set aside any commercial production that could interfere with meeting the required DoD delivery date. These activities require substantial investments of time and opportunity costs that are not captured in the "cost" of the product as reported by the IG. Critically, these production dynamics and the "razor/razor blade" approach to sales are standard in the aerospace spare-parts industry and describe the market reality that drives TransDigm's pricing.

Federal Acquisition Regulations and Commercial Pricing

Please remember, TransDigm is primarily a commercial supplier—not a traditional defense contractor. As you know, the Federal Acquisition Regulations (FAR) require that contracting officers buy products and services at "fair and reasonable" prices. But, as a general proposition, the fairness and reasonableness of prices that the DoD pays for commercial items is determined by market prices generated in the commercial marketplace. Certified supplier cost information is only required for procurements in excess of \$2 million dollars of non-commercial items that are not competitively bid. Notably, the IG report addresses only one contract where certified cost data was required and in that case, it was provided. Where procurements are of commercial items or are competitive, contracting officers can—and should—rely on other information to establish price reasonableness.

Congress enacted the Federal Acquisition Streamlining Act (FASA) and the subsequent Federal Acquisition Reform Act (FARA), as well as recent amendments to those laws, to facilitate the federal government's reliance on the commercial marketplace and emulate commercial-style buying practices, especially in situations where competition was not feasible.³ Before these laws were enacted, there was no preference or clear mandate for the government's acquisition of commercial items in the open market. FASA established a preference for commercial item purchase by making price analysis, not cost analysis, the norm and reducing the number of otherwise onerous government-unique requirements applicable to procurements of commercial items. This was intended to encourage commercial contractors to enter into government contracts by reducing the information burden on contractors that are neither equipped nor interested in supporting cost analysis.⁴ In fact, before this very Committee, it was noted that the commercial-item exception was specifically designed to promote "the Government's acquisition of commercial goods and services by seeking to establish more

³ S. Rep. 103-258, 1994 U.S.C.C.A.N. 2561 at 2566 (May 11, 1994) (the purpose of FASA was to "create a new commercial item exception", contemplating that "[t]his approach shall be used *where competition is not feasible* and adequate information on commercial prices in [sic] available to determine price reasonableness.") (emphasis added). See also *id.* at 2580 ("[t]he new exception *shall be used where competition is not practicable...*") (emphasis added).

⁴ The legislative history underlying FASA and FARA provides explicit statements supporting this purpose: "Title VIII includes provisions that would reduce impediments to the purchase of commercial items by exempting such purchases from a series of statutes that are unique to government purchases, and that have no counterpart in the commercial sector" (emphasis added). S. Rep. 103-258, 1994 U.S.C.C.A.N. 2561 at 2566 (May 11, 1994). "The bill... would amend the Truth In Negotiations Act for DOD and civilian agencies to create a new commercial item exception.... This approach would relieve commercial contractors from what they consider their number one disincentive to participating in government procurements — the burden of collecting cost data for the government" (emphasis added). S. Rep. 103-258, 1994 U.S.C.C.A.N. 2561 at 2566 (May 11, 1994).

commercial-like procedures which will free businesses from remaining Government data and audit requirements, simplify the sale of commercial items and promote the Government's use of commercial sources.⁵

The Inspector General's Audit Report

For parts that qualify as commercial items, the FAR requires contracting officers to use price analysis to determine whether the price being offered by the contractor is fair and reasonable.⁶ Contracting officers are directed to use price comparisons with historical prices from previous purchases, current price lists, catalogs or advertisements, an independent government estimate, or prices identified through market research for the same or similar items, as well as analysis to identify pricing inconsistencies.⁷ Only as a last resort should contractors request uncertified cost data.⁸ In TransDigm's case, of the 47 parts audited, 43 of the parts are in fact commercial items. In all of the contracts reviewed by the IG, the contracting officers found TransDigm's prices fair and reasonable.

In auditing those purchases, however, the IG ignored the FAR provisions regarding commercial-item contracting; ignored that many of the parts were not sole-source and had adequate competition; and failed to take into account how TransDigm, and companies like TransDigm, actually do business in the aftermarket. Using an arbitrary profit percentage and cost analysis inconsistent with the FAR and Congressional intent, the IG determined that TransDigm's calculated profit from those sales was excessive. But, the IG also found that the contracting officers who reviewed the spare parts that the DoD bought from TransDigm followed all applicable laws, rules, and regulations—and importantly, that TransDigm did nothing illegal in its pricing.

Keeping in mind the fundamental differences between how the commercial suppliers and traditional defense contractors do business with the government and the laws that exist today, we suggest the following. As to commercial companies, like TransDigm, and commercial items and items for which there are competitive sources, the relevant inquiry as to profit should not be whether the prices that the DoD paid for TransDigm's products are reasonable as compared to some arbitrarily established percentage mark-up over cost. If this approach were adopted, some government suppliers may exit the market, leaving holes in the DoD's supply chain. Instead, we should maintain the approach Congress intended, that is, determining whether those prices are reasonable as compared to the same or similar items that have been bought and sold in the commercial market.

Under that standard, the answer in TransDigm's case is, "yes." As I described a moment ago, high profit margins are prevalent throughout the aftermarket for spare parts and the profit that TransDigm earns on its parts lie within industry norms. Moreover, TransDigm earns comparable profit from the sale of a commercial part and the sale of the commercially comparable part to a commercial customer. Further, in total, TransDigm's defense aftermarket margins are lower than its commercial aftermarket margins by a full 10 percentage points.

⁵ H.R. 1570, The Federal Acquisition Reform Act of 1995, Joint Hearing Before the Committee on Government Reform and Oversight and the Committee on National Security House of Representatives at 2 (May 25, 1995) (emphasis added).

⁶ FAR 15.403-3(c)(1).

⁷ FAR 15.404-1(b).

⁸ FAR 15.403(c)(1) and (c)(2).

Finally, we believe TransDigm's defense aftermarket profits are generally consistent with those of its peers.

Responses to False Public Claims

With the foregoing in mind, I would like to address squarely allegations that have been publicly made against TransDigm and explain why each is not true.

First, TransDigm has been price gouging its products with mark-ups over cost from 17% to 4,451%.

The IG audit reviewed 48 parts purchased through 113 contracts between January 2015 and January 2017 with a total value of \$29.7 million. The IG omitted one of those transactions because certified cost data was provided. Of the 47 remaining parts audited, 43 are in fact commercial items—for which the FAR does not require even uncertified cost data to establish price reasonableness.

The IG's conclusion that TransDigm earned excess profit of \$16.1 million on 46 of the 47 parts purchased is based on cost data that excludes many actual costs of doing business. The informal cost data provided by TransDigm is understated (and the profit is overstated) because TransDigm provided estimated standard costs, which excludes costs previously mentioned like set-up times and switching costs—unique to but not unusual in the spare-parts aftermarket. Furthermore, many general and administrative costs, such as, taxes, interest expense, litigation costs, acquisition costs, and patent costs—all of which are normally recognized under generally accepted accounting principles—are excluded from the federal government's cost calculation and, therefore, do not reflect the actual full costs incurred by TransDigm necessary to conduct the business and provide parts to customers—commercial and government.

Finally, it must be understood that what is "fair and reasonable" under government procurement guidelines is generally flexible. The final determination is left to the discretion of contracting officers, who in this case originally found that prices paid were fair and reasonable. The prices paid by the DoD were comparable to the prices paid by a commercial customer. To be clear, the law does not provide for any maximum allowable margin on the fixed-price-type contracts that constitute the bulk of TransDigm's business with the government. Indeed, despite the fact that the IG arbitrarily determined that a mark-up over cost of 15% was reasonable for purposes of this audit, it is not unusual for the DoD to accept as reasonable price increases of up to 25% without justification and the FAR anticipates that scenario.⁹ I will say it again: in all of the contracts reviewed by the IG, the contracting officers found TransDigm's prices fair and reasonable and the IG found that the contracting officers and TransDigm followed applicable laws.

Second, TransDigm has failed to release its cost information to procurement officers.

Of the 47 parts audited, 43 were commercial items. Further, 10 had adequate sources of competition—whether or not the award was pursuant to a competitive bid. The DoD could have used full-and-open competition to acquire those parts, which would have mooted the need for data, but it chose to use a sole-source acquisition strategy. In addition, 33 were at or below the simplified acquisition threshold, which was then \$150,000.

In all these cases, the applicable regulations do not require certified cost and pricing data to establish price reasonableness and contracting officers are directed by the FAR to establish

⁹ See OFAR 217.7505.

fair and reasonable pricing using price analysis. Cost analysis is to be used only as a last resort. In fact, the IG states that there was "no specific requirement in the FAR or DFARS that required or compelled contractors to provide uncertified cost data when requested." Further, he concurs that contracting officers are supposed to use a hierarchy of price analysis, noting "[s]tatutory and regulatory requirements discourage contracting officers from asking for uncertified cost data when determining whether a price is fair and reasonable." In all cases, TransDigm complied with the applicable laws, rules, and regulations governing the pricing of its contracts.

Third, TransDigm has created a false network of subsidiaries disguised as competitors, thus monopolizing the market.

This statement, which was not addressed by the IG Report but has been repeated publicly, at best reflects a fundamental misunderstanding of how TransDigm is structured and why it is structured this way. First, I note that very few TransDigm operating units provide products that are capable of competing against each other and to the extent they do so, it is almost always at the OEM development stage—not in the aftermarket. I am not aware of any situation where two TransDigm operating units provide competing products directly to DoD. Second, TransDigm does not own any distributors contrary to public assertions. In short, this accusation is simply false.

Fourth, TransDigm operates as a monopolist and does not develop any products itself but rather only acquires proprietary parts businesses and raises prices.

By way of background, producing and selling a sole-source part is not synonymous with having a monopoly. A sole-source product is the only one qualified for a specific application. But, at the initial development of the product, there was likely robust competition for the original development and OEM production award. Further, a second source can—and often does—later develop a competing product for sale to the OEM and/or the aftermarket. In fact, three of the 47 parts that were subject to the audit have been second-sourced in the last few years. This is beyond the 10 parts already mentioned that had competitive sources of supply. In addition, several DoD branches, such as the Strategic Alternate Sourcing Program Office of the Air Force Sustainment Center, are actively promoting their alternate sourcing programs to develop alternate sources of supply, create new repair protocols and capabilities, promote reverse engineering of parts, and promote the utilization of used and overhauled parts. At any time, on any one of our hundreds of thousands of products, a second source can be introduced if a competitor makes the decision to invest in developing and qualifying the product.

With regard to acquisitions and product development, while it is true that TransDigm has grown its business through the acquisition of companies with existing products and existing customers in the commercial and defense markets, TransDigm undertakes significant engineering projects resulting in new innovative products, improved existing products, and better manufacturing methods. With approximately 3,000 engineers worldwide and electing to spend almost \$300 million in R&D over the last five fiscal years, TransDigm was recently recognized by Forbes as among the world's most innovative companies.

For example, prior to 9/11, TransDigm's Adams Rite subsidiary manufactured the cockpit door locking system on the Airbus A300/A320 utilizing basic technology to address rapid decompression and a basic door handle lock. But, after 9/11, the industry needed a more robust door locking system, while balancing the need to handle a rapid decompression event. Airbus contracted with Adams Rite in 2002 to develop such a system, and in eight months, Adams Rite had developed and tested the system. Today that system flies on over 11,000 aircraft. Soon thereafter, Airbus asked Adams Rite to develop an entire cockpit door

module for the A380, consisting of the door panel, locking system, keypad, camera, and decompression sensor—something Adams Rite had never done before. At the time, Airbus was having industrialization problems and its current door was overweight and expensive. Today, Adams Rite's cockpit door module is the most reliable and advanced door in the market, balancing three key risks of intrusion, ballistics, and rapid decompression. The system responds to a decompression event in less than five milliseconds—the only door in the world to do so. In addition, on the A380, Adams Rite achieved a 20% weight reduction and 10% cost reduction over Airbus' original design. Today our cockpit door module is flying on over 465 A380 and A350 aircraft. On the two projects combined, we spent almost \$11 million of our own R&D funds and invested \$2.3 million in capital equipment.

On the military side, Whippany Actuation Systems designed and manufactures a control actuation system that enables the conversion of "dumb" unguided 70-mm rockets to smart laser-guided missiles, giving warfighters a low-cost, highly accurate strike capability. The advanced precision kill weapon system laser-guided rocket is available to all four U.S. military branches and is able to launch from rotary and fixed wing aircraft. Whippany has hired 170 additional employees in connection with its ramp up in manufacturing volume from 1,400 parts in 2015 to over 12,000 parts in 2018 to support full rate production and surge capacity requirements, while maintaining a quality rating of over 99.85% and on-time delivery of over 98%.

TransDigm encourages its independent operating units to prioritize high quality and on-time delivery. With this in mind, the Company's AvtechTyee subsidiary was just last month named a recipient of Sikorsky Program Supplier of the Year. Sikorsky noted, "AvtechTyee was a vital supplier on Sikorsky's future vertical lift platforms, S-97 Raider and SB-1 Defiant. Their innovative contributions were highlighted by the first use of composite pitch control rods on a Sikorsky program. AvtechTyee successfully designed a unique carbon fiber rod under the strict time constraints of Sikorsky's rapid prototype environment. AvtechTyee showed a great deal of agility in balancing priorities to ensure both programs' critical milestones were met." In addition, last month the Company's Data Device Corporation subsidiary was named General Atomics Aeronautical Systems, Inc. Supplier of the Year for the third year in a row for having a 100% quality rating and 100% on-time delivery rating, placing DDC in the top 1% of General Atomics' supply base.

We make acquisitions with the intention of holding them long-term. The focus after we buy a business includes:

- Streamlining the business into a focused structure with simple lines of authority and autonomous decision-making.
- Improving reliability, quality, and delivery. This is the real value to our customers and the best way to sustain market position.
- Improving efficiency. We invest capital as necessary and effectively.
- Focusing and refining the new business generation process. We have distinguished ourselves in getting new or improved products selected on most new airplane development programs.
- When contract, regulatory, or market conditions permit, we initially look to price the products to reflect our view of the market and value. We invest significantly to own and provide high quality engineered products and work hard to deliver them on time. This has significant value to our customers.

Yes, pricing is one of a number of elements that we review when we analyze and acquire businesses, but it is one of many factors.

For example, TransDigm acquired its Kirkhill business in March 2018. Since the acquisition, Kirkhill has added almost 100 employees and introduced entry-level wage increases to stay ahead of the new Los Angeles County minimums and attract new employees. The Company will invest close to \$9 million in infrastructure and productivity capital projects this year. Consequently, employee turnover has decreased and delivery and quality has improved since the acquisition, although there is still more improvement to be done.

Fifth, TransDigm is further monopolizing the market by trying to acquire Esterline.

TransDigm appreciates the DoD's continuing interest in the integrity of the defense industrial base and its concerns about excessive consolidation that can erode that industrial base. For this reason, TransDigm provided extensive and detailed information responsive to DoD's data requests regarding its acquisition of Esterline. There is very little overlap in competitive capabilities between the legacy TransDigm and the legacy Esterline businesses and little to no competition at a DoD procurement level. Notably, the DoD, as well as the Department of Justice and the Federal Trade Commission, made no objections, in whole or in part, to the acquisition, which was consummated in March 2019.

Conclusion

We hope these explanations will help dispel confusion about TransDigm and how TransDigm does business, particularly business in connection with the Department of Defense. While TransDigm's defense sales are a distinct minority of its overall business, we are enormously proud of the opportunity that our employees have in contributing to the defense of the Nation. We are extremely proud of the innovation we help bring to the Department's ability to defend the Country and its interests in an increasingly dangerous world.

Thank you for the opportunity to appear before you today and introduce TransDigm and discuss our business model and the aviation spares aftermarket. We look forward to answering your questions.

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